DOCUMENT RESUME

ED 319 099 EA 021 695

TITLE	Personal Income Taxation. National Education Association Search.
INSTITUTION	National Education Association, Washington, D.C. Research Div.
PUB DATE	87
NOTE	30p.; For related documents, see EA 021 694-697.
AVAILABLE FROM	NEA Professional Library, P.O. Box 509, West Haven, CT 06516.
PUB TYPE	Reports - Evaluative/Feasibility (142)
EDRS PRICE	MF01/PC02 Plus Postage.
DESCRIPTORS	*Educational Equity(Finance); Educational Finance; Elementary Secondary Education; *Finance Reform; *School Support; School Taxes; Tax Allocation; *Tax Rates
IDENTIFIERS	*Income Taxes; National Education Association

ABSTRACT

The second in a series on school finance, this report describes the principles of fair and adequate state and local income taxation. The political setting is discussed, and the nature of indiviudal income taxes is explained by examining which states tax income and what income they tax. Tables 2, 3, and 4 demonstrate the expanding school financing role of the states and individual income taxes as a percentage of total state taxes. The following issues and topics about taxing individual income are reviewed: principles of taxation; tax equity; constraints on tax rates; progressive taxation; inflation and indexing; the income tax as a social and economic policy tool; the lack of conformity among federal, state, ad local income taxes; and tax competition. Tables related to this material generally illustrate the responsiveness of state personal income taxes to changes in taxpayers' income elasticity--a factor that comments on the progressivity and the regressivity of the income tax and its potential for offering financial support to school districts. Several state practices are identified that tend to reduce its yield to the detriment of educational support. The potential for additional revenues are also discussed. The findings are that the income tax is and should continue to be an important source of school finance means and that the states must ensure that it is levied in a manner that facilitates equity and taxpayer compliance. (JAM)

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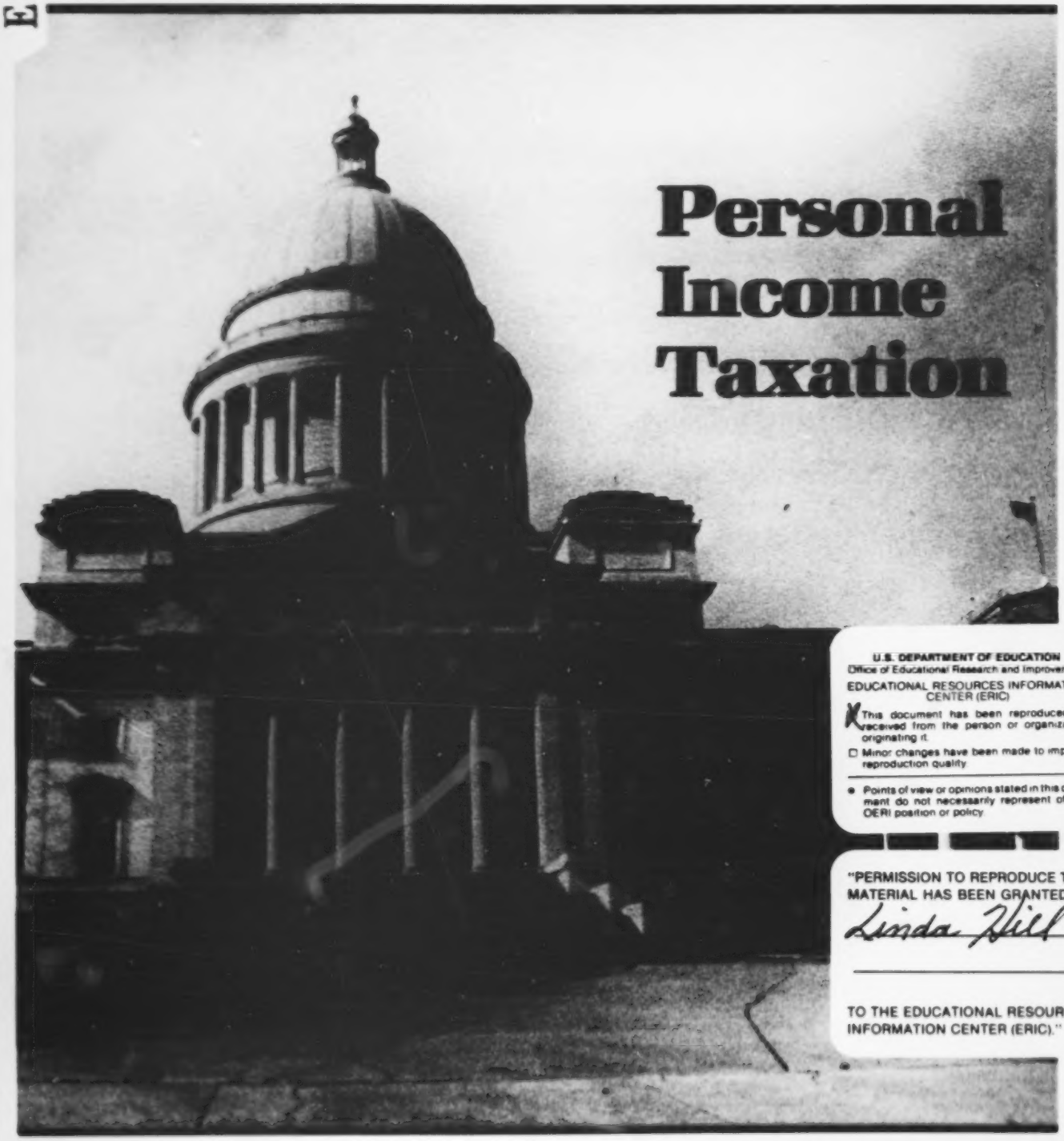

Personal Income Taxation

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Foreword

State governments account for slightly more than half the revenue used to support public education in the United States. State governments rely most on both the personal income tax and the general retail sales tax for their revenues. The linkage between support for public education and these taxes is therefore significant. Indeed, the nature and scope of state taxation profoundly affects the level of compensation of education employees and is accordingly a concern of the NEA.

The principles of fair and adequate taxation are well known. In the political process these principles are adhered to or violated, with consequences for education and for all of the other activities undertaken by our governments. The consequences are obvious or subtle but nonetheless important.

When special provisions in tax laws reduce the tax base—narrowing in some way the definition of taxable activities—those favored activities are given a higher priority by the government than other activities. This condition arises because the money that would have been collected by the ordinary definition of the tax base is never received by the government. The legislative body accordingly has no opportunity to weigh the tax revenue foregone by the special provision when it weighs other demands for spending the government's resources. Thus, those interested in adequate support for public education must be alert to the possibility that their goal is jeopardized by those who seek special tax treatment.

This pamphlet describes the principles of fair and adequate state and local income taxation. It refers, as appropriate, to federal income taxation where federal practice influences state and local tax policy. The pamphlet also identifies several state income tax practices that serve to narrow the scope of the tax and reduce its yield to the possible detriment of educational support as well as support for other essential functions.

The conclusions and findings of this report suggest actions necessary to preserve and maintain the income tax as a strong contributor to a fair, diversified, and high-yielding state tax system.

We believe that Association leaders at all levels will find this publication a useful reference document when the issue of public support for education arises and it is necessary to seek changes in the state/local tax system to obtain additional revenue.

The manuscript was prepared by Jack P. Suyderhoud of the University of Hawaii under a contract with NEA. He acknowledges the helpful criticism he obtained from NEA staff and his professional colleagues.

August 1987

Setting

As taxpayers, members of the education profession should have an interest in how states and localities tax personal incomes. Policy decisions made at the statehouse will affect their take-home pay and that of their fellow taxpayers. More specifically, however, educators employed in the public sector should be aware that the function of individual income taxes is to generate revenues to finance state expenditures. State spending is increasingly dominant in financing public education. To be effective, such support should be predictable, stable, and consistent. Since states are becoming more reliant on income taxes as a revenue source, it is in the interest of educators to also encourage income taxes that generate adequate revenues both at present and in the future.

Increased public interest in state and local income taxes has been promoted by the Federal Tax Reform Act of 1986 (TRA). Since virtually all states and localities that levy income taxes use rules and regulations that conform in part to federal definitions, changes in the federal tax code will have profound implications for state and local income taxes.

Policy makers at the state and local level will have to decide to what extent their taxes should reflect the recent and likely subsequent federal changes. The thrust of federal individual income tax reform has been to reduce the opportunities to exclude income and to eliminate deductions from income. This base broadening makes possible generally lower tax rates and the removal of low-income taxpayers from the tax rolls by raising personal exemptions and standard deductions.

Nature of Individual Income Taxes

Who Taxes Income

In our federal system it is possible for all three levels of government, local, state, and federal, to tax any of the major tax sources: property, sales, and income. Historically, the sources were separated to a large degree. The property tax has been largely the domain of local government. General sales taxes have been the almost exclusive purview of state governments. However, the individual income tax is an exception in that income is taxed at all three levels, although to varying degrees.

Even though individual income is taxed by all three levels of government, the federal role is dominant. Wisconsin was the first state to adopt an individual income tax in 1911. The Territory of Hawaii levied an income tax starting in 1901. The federal income tax was enacted in 1913 and grew substantially with impetus provided by the two world wars, so that today the federal government dominates the taxation of income. In terms of revenue collections, federal collections are five times that of state and local receipts. In terms of administration, federal definitions, rules, and regulations are generally adopted by states.

What Income Is Taxed

The individual income tax is intended to be levied on an ability-to-pay principle. That is, taxpayers with a greater ability pay a larger tax, where

income is the measure of ability to pay. In adopting an income tax, jurisdictions must determine what type of income to tax. Table 1 shows the theoretical process of defining a tax base. It starts with a large amount of comprehensive income from which there can be exclusions. Some of these exclusions are necessary to make the tax manageable (e.g., unrealized capital gains) and some are a matter of social choice (e.g., exclusion of employee fringe benefits). The exclusions serve to narrow the potential tax base to an adjusted income amount. From this, exemptions can be allowed so as not to tax subsistence income and deductions may be provided so that taxable income more accurately reflects the true ability of the taxpayer to pay.

Considerable variation exists in the type of income that is subject to tax, both historically and across jurisdictions. The federal individual income tax started with low rates and provided generous exemptions so that only relatively high-income households were subject to the levy. Over time, tax rates increased and a larger proportion of households became subject to taxation. The higher rates also brought forth pressure for tax preferences in the form of exclusions, exemptions, and deductions. The Tax Reform Act of 1986 reversed this trend by reducing rates while reducing the so-called "loopholes."

Among jurisdictions there are a variety of ways in which taxable income is defined. The federal definition of taxable income, especially given the changes of the 1986 Tax Reform Act, is generally regarded as comprehensive. That is to say, virtually all types of money income are taxed with relatively few exceptions. However, Pennsylvania's base is even broader since no exemptions or deductions are allowed. In contrast, the income tax base in Connecticut consists only of interest, dividends, and capital gains, while New Hampshire and Tennessee tax only interest and dividends. State laws often limit local jurisdictions to taxing only wage and salary income.

TABLE 1. Defining the Income Tax Base

Start with:	Comprehensive income*
Deduct:	Exclusions from comprehensive income (e.g., employee fringe benefits, relief payments, portions of capital gains, moving expenses, Individual Retirement Accounts)
Equals:	Adjusted income (e.g., adjusted gross income)
Deduct:	Personal exemptions Standard or itemized deductions
Equals:	Taxable income (income tax base)

*Comprehensive income includes anything that increases wealth and/or facilitates consumption, whether it is monetary income or in-kind income, e.g., paid medical benefits or a company-paid car.

The Expanding Role of States and Income Taxes

State/Local Shares

For the nation as a whole, it is clear that state governments are playing an increasingly dominant role in financing public education. Between the 1959-60 and 1985-86 school years, the states' share of direct elementary and secondary education revenues increased from 39.5 to 50.9 percent. (See Table 2.) Over this same period, the proportion contributed by local governments fell from 56.8 to 43.5 percent. The federal contribution rose from 3.7 percent in 1959-60 to 9.2 percent in 1979-80 but has since fallen to 6.4 percent. These trends are explained by a number of factors including court-mandated state equalization programs, productive state tax systems relative to limited local tax resources, local tax "revolts," and changing political agendas related to the appropriate federal and state roles in local public education.

The national averages discussed above camouflage the wide variation in the importance of state financing among the 50 states. Table 3 shows that the state share of public education rev-

TABLE 2. Federal, State and Local Receipts for Public Schools, 1959-60 to 1985-86

	Revenue Receipts (in thousands)					
	Federal		State		Local and Other Sources	
School Year	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total
1959-60.....	N/A	3.7	N/A	39.5	N/A	56.8
1975-76.....	$5,948,918	8.5	$30,616,967	43.7	$33,463,141	47.8
1976-77.....	6,354,615	8.4	32,983,433	43.8	35,965,346	47.8
1977-78.....	7,231,520	8.8	36,369,088	44.3	38,545,341	46.9
1978-79.....	7,769,190	8.8	41,524,286	47.3	38,506,927	43.9
1979-80.....	9,020,165	9.2	47,928,660	49.1	40,685,963	41.7
1980-81.....	9,285,193	8.7	51,375,525	48.2	45,891,602	43.1
1981-82.....	8,409,383	7.4	54,695,616	47.9	50,970,234	44.7
1982-83.....	8,439,309	7.0	57,593,256	47.9	54,291,572	45.1
1983-84.....	8,645,484	6.7	61,876,529	48.1	58,204,457	45.2
1984-85.....	9,269,362	6.6	69,302,354	49.6	61,062,982	43.7
1985-86.....	9,588,136	6.4	75,032,891	50.1	65,066,970	43.5

SOURCE: All years except 1959-60: *NEA Estimates of School Statistics, 1985-86,* p. 21. For 1959-60: Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism, 1985-86,* p. 39.

enues in 1985-86 ranged from 5 percent in New Hampshire to 91 percent in Hawaii, with most states in the 40-60 percent range. There appears to be no regional pattern that would explain differences among states. This suggests that the role the state chooses to exercise is primarily a function of state-specific historical traditions and circumstances.

TABLE 3. Percent of Public School Revenues by Source, by State, 1985-86

	Federal	State	Local and Other
50 STATES AND D.C. ..	6.4	50.1	43.5
NEW ENGLAND	5.3	40.5	54.2
Connecticut	4.9	40.5	54.5
Maine	7.7	51.1	41.2
Massachusetts	5.3	44.0	50.7
New Hampshire	3.8	5.0	91.2
Rhode Island	4.1	41.9	54.0
Vermont	6.2	35.6	58.2
MIDEAST	4.5	43.9	51.7
Delaware	7.7	68.7	23.5
Dist. of Columbia	6.7	. . .	93.3
Maryland	5.8	40.4	53.8
New Jersey	4.7	44.7	50.6
New York	3.6	43.9	52.5
Pennsylvania	5.0	45.3	49.7
SOUTHEAST	9.1	56.0	34.9
Alabama	11.1	73.4	15.0
Arkansas	10.3	61.3	28.3
Florida	8.0	53.4	38.6
Georgia	8.1	55.8	36.1
Kentucky	10.4	68.6	21.0
Louisiana	10.9	53.2	35.9
Mississippi	17.0	57.2	25.8
North Carolina	7.9	64.2	27.9
South Carolina	9.0	58.9	32.1
Tennessee	9.7	50.0	40.3
Virginia	6.4	36.1	57.5
West Virginia	9.8	63.8	26.5
GREAT LAKES	5.2	42.9	51.9
Illinois	7.3	39.2	53.5
Indiana	3.7	58.2	38.1
Michigan	4.7	36.6	58.7
Ohio	5.0	46.3	48.7
Wisconsin	4.0	39.8	56.2
PLAINS	5.6	43.7	50.7
Iowa	5.8	40.7	53.5
Kansas	4.6	44.6	50.8
Minnesota	4.2	54.4	41.3
Missouri	6.6	38.9	54.5
Nebraska	5.1	28.1	66.8
North Dakota	8.1	53.5	38.4
South Dakota	11.1	27.8	61.1
SOUTHWEST	7.8	50.5	41.7
Arizona	10.0	53.3	36.7
New Mexico	12.8	75.4	11.9
Oklahoma	5.1	64.1	30.8
Texas	7.4	46.0	46.6
ROCKY MOUNTAINS	5.0	45.1	49.9
Colorado	5.1	36.0	58.2
Idaho	6.3	65.6	28.2
Montana	6.4	51.7	41.9
Utah	5.3	55.6	39.1
Wyoming	2.3	37.4	60.3
FAR WEST	7.0	66.4	26.6
Alaska	3.3	74.6	22.1
California	7.7	68.7	23.7
Hawaii	9.3	90.6	0.2
Nevada	3.9	34.1	62.0
Oregon	4.8	27.9	67.3
Washington	5.7	75.6	18.7

SOURCE: NEA, *Estimates of School Statistics 1985-86*, p. 39.

The contribution of state and local personal income taxes to financing public education is almost exclusively indirect. Only some school districts in Iowa, Ohio, and Pennsylvania directly tax income, and this accounted for a mere 0.8 percent of school district revenues nationwide.

State Income Tax Growth

To the extent that the states have increasingly funded education from tax revenues, the income tax has played a significant role in providing states with the ability to do so. Personal income taxes contributed 29.6 percent of state tax revenues in 1985, up from 24.0 percent in 1976 (see Table 4), and 15.4 percent in 1967. Income taxes were even more important at the margin: for the period 1967-1985, aggregate state tax collections grew by $182 billion and of this growth, personal income taxes accounted for $59 billion, or 32.5 percent.

The growth of state personal income tax revenues is a result of several factors. First, new income taxes were enacted by states that previously did not tax income. Prior to 1961, 31 states plus the District of Columbia levied personal income taxes. In the 16-year period from 1961-1976, 10 states adopted personal income taxes including the populous industrial states of Indiana, Michigan, Illinois, Ohio, Pennsylvania and New Jersey. Presently, 40 states levy broad-based income taxes. Another three (Connecticut, New Hampshire, and Tennessee) tax only narrowly defined types of income. Seven other states do not levy income taxes (Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming). (Alaska repealed its income tax in 1979).

TABLE 4. Individual Income Taxes As Percentage of Total State Taxes

State	1976	1980	1982	1984	1985
NEW ENGLAND					
Connecticut	3.9	5.5	5.8	9.0	8.3
Maine	9.8	23.0	28.7	28.5	29.6
Massachusetts	44.6	47.4	48.3	47.8	47.7
New Hampshire	3.4	3.9	4.6	5.3	5.6
Rhode Island	24.0	27.9	31.9	35.2	32.7
Vermont	28.7	31.2	33.9	32.0	31.6
MIDEAST					
Delaware	39.4	45.7	48.1	48.2	44.8
Maryland	40.3	39.7	42.4	40.7	40.9
New Jersey	4.4	24.5	23.5	24.8	25.1
New York	40.4	45.4	52.0	49.8	50.2
Pennsylvania	20.7	23.1	24.3	26.4	25.5

Table continued on page 11

TABLE 4. (Continued)

State	1976	1980	1982	1984	1985
SOUTHEAST					
Alabama	18.1	21.4	21.9	23.0	24.3
Arkansas	20.4	27.3	28.0	28.2	27.0
Georgia	24.6	32.0	36.0	37.1	38.0
Kentucky	20.8	23.6	24.1	25.4	25.8
Louisiana	7.1	10.3	7.0	13.0	13.7
Mississippi	12.0	11.9	11.5	14.9	14.3
North Carolina	29.4	36.7	38.2	38.5	38.9
South Carolina	23.4	29.5	32.8	33.4	31.1
Tennessee	1.7	1.6	2.1	2.2	2.1
Virginia	33.7	40.2	44.7	43.3	43.6
West Virginia	16.9	20.7	20.8	23.0	27.1
GREAT LAKES					
Illinois	25.4	26.9	29.9	34.0	28.2
Indiana	21.2	20.7	24.4	30.0	29.7
Michigan	30.0	32.2	33.7	39.5	35.1
Ohio	15.5	21.8	21.4	31.1	32.2
Wisconsin	39.6	42.5	42.7	42.6	39.7
PLAINS					
Iowa	32.4	34.5	36.1	35.2	35.7
Kansas	22.7	26.5	31.9	31.7	31.5
Minnesota	38.3	39.4	40.8	45.6	42.7
Missouri	24.6	28.8	32.9	29.6	31.4
Nebraska	21.6	28.9	26.3	28.5	30.7
North Dakota	20.4	14.3	6.6	10.8	11.0
SOUTHWEST					
Arizona	16.0	17.1	23.7	20.9	20.7
New Mexico	10.1	5.1	1.3	5.4	5.9
Oklahoma	20.1	20.4	23.6	24.7	24.4
ROCKY MOUNTAINS					
Colorado	33.2	30.9	32.4	35.8	39.7
Idaho	30.0	32.5	38.0	33.1	35.2
Montana	35.1	31.0	27.2	29.2	28.3
Utah	29.6	33.8	34.8	32.3	32.5
FAR WEST					
Alaska	24.4	7.0	0.1	0.1	0.1
California	27.7	33.4	34.2	36.1	37.2
Hawaii	28.9	31.2	26.5	32.3	31.5
Oregon	57.2	59.6	62.4	65.8	66.1
ALL STATES	24.0	27.1	28.1	30.0	29.6

SOURCE: U.S. Bureau of the Census, *State Government Tax Collections*, various years.

Discretionary legislative changes in the personal income tax laws account for a second source of revenue growth. These changes include raising tax rates and tightening "loopholes" by reducing income exclusions and deductions. In the 1981-85 period, there were 33 such discretionary changes made by 22 states.

Income tax revenues have also grown in response to real and inflationary economic growth. Real growth, a result of expanding population and real economic activity, means more people have more income and thus pay more taxes. If the tax structure is graduated, tax revenues will grow faster than income since growth puts taxpayers into higher tax brackets. Inflation has the same effect but without increasing taxpayers' buying power. Unless tax brackets and deductions are adjusted, inflated incomes push taxpayers into higher tax brackets which results in higher tax revenues. It is estimated that for the period 1966-1981, a time that included periods of historically high inflation, growth in overall state tax collections because of inflation was three times larger than that due to real economic growth.

Differences Among States

Reflecting the variety of fiscal preferences and experiences, there are considerable differences in states' reliance on income taxes. (See Figure 1.) Table 4 shows that for those states that tax broad-based income, the relative contribution of income taxes to total states' tax collections ranged from 66 percent in Oregon (which has no general sales tax) to 6 percent in New Mexico, with most states relying on the individual income tax for 30 to 50 percent of tax collections. For virtually all states, the relative contribution of income taxes has increased over the period covered in Table 4.

Local Income Taxes

In response to the fiscal pressures faced by local governments, several states have granted local governments the power to levy individual income taxes. The most widespread use of the local income tax occurs in Pennsylvania where 2,758 government units levied the tax in 1985. In ten other states that permit local income taxation, 467 jurisdictions did so in 1985, up from 385 in 1976.

Local income taxes are a small, but growing source of revenue. Collections from these taxes increased from 3.2 percent of nationwide local tax revenues in 1967 to 5.3 percent in 1985. Where local individual income taxes are levied, they can account for a substantial portion of tax revenues. In Maryland, Kentucky, and Ohio, more than 20 percent of local tax revenues are from individual income taxes. (See Table 5.)

FIGURE 1. Importance of Income Taxes

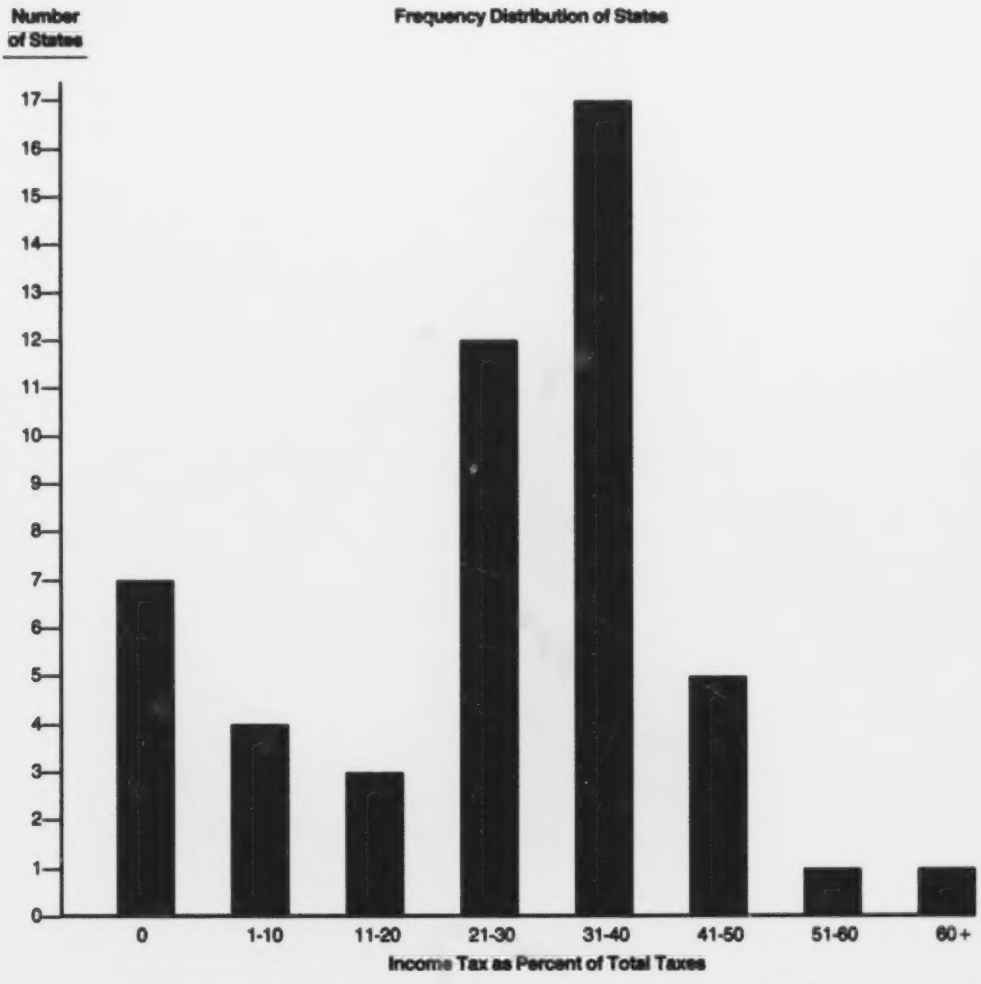


TABLE 5. Local Income Tax Collections, Fiscal Year 1984

(Millions)

State	All Taxes Combined	Individual Income Tax Revenue	Percent of Total Taxes
United States....	$123,398.5	$5,679.9	4.6%
Alabama	949.3	37.6	4.0%
Delaware	145.4	16.3	11.2%
Indiana	1,965.4	80.4	4.1%
Kentucky	755.6	152.6	20.2%
Maryland	2,588.7	749.7	29.0%
Michigan.....	5,728.3	312.9	5.5%
Missouri.....	2,017.3	136.4	6.8%
New York	18,959.5	1,551.4	8.2%
Ohio	5,412.6	1,120.0	20.7%
Pennsylvania..	5,973.1	1,042.1	17.4%

SOURCE: ACIR data disk based on data from Census' Government Finance tape for FY 84.

In all cases, the state places constraints on which local jurisdictions can tax individual income and how the tax can be structured. Most states allow only cities and/or counties to levy the tax. However, Pennsylvania, and, to a lesser extent Iowa and Ohio, permit school districts to levy an income tax. For ease of administration, the tax bases are restricted to wages or state taxable income, and all states (except New York) require flat tax rates.

Issues in Taxing Individual Income

Principles of Taxation

In evaluating the individual income tax, several principles are widely accepted. First, it should generate revenues adequate to meet present needs and should be responsive to meet future needs. Second, the tax should be fair. Third, it should not be a source of economic dislocations. Fourth, it should be easy for taxpayers to comply with and for governments to administer. Fifth, since the income tax is essentially self-assessed, i.e., the determination of tax liability is left largely to the taxpayer and his or her conscience, it is essential to maintain public confidence in the tax.

Translating the principles of taxation into specific language contained in a tax code is difficult. This is owing in part to conflicts among the principles listed above. For example, an individual income tax that is fair by taking into consideration the particular financial circumstances of the taxpayer through exclusions and deductions will be more cumbersome to comply with than one that taxes income with few such exclusions or deductions.

Nevertheless, there are standards by which to evaluate the income tax: the income tax should be broad-based allowing few exclusions from income; all income should be uniformly treated; tax rates should be low, given the revenue requirements; subsistence income should not be taxed; and the tax should be free of uncertainties, with infrequent changes in definitions and tax rates. Given these standards, several important aspects of state and local income tax policies will be reviewed.

Tax Equity: Fairness and Progressivity

Notions of fairness in taxation are easy to assert but difficult to implement. If it is recognized that income is the measure of ability to pay, it follows that families with equal income should pay equal taxes. This is seldom the case since not all income is treated equally under tax laws, and taxpayers differ in terms of exemptions and deductions. For example, Table 6 shows how three Hawaii families with equal incomes would have had considerably different income tax liabilities under the 1986 Hawaii income tax law, a law that is representative of most state income taxes.

A second dimension of equity involves determining how the tax burden should be distributed among taxpayers at varying income levels. This is the issue of tax progressivity. A tax is said to be progressive if the tax liability *as a percent of income* increases as income increases. Conversely, if the percent of income paid in taxes decreases as income increases, the tax is said to be regressive. A proportional tax is one in which the tax as a percent of income remains constant as income changes.

TABLE 6. Simulated Income Tax Liabilities for Three Hawaii Families, 1986*

	Family**		
	A	B	C
Income			
Wages	$30,000		
Interest		$15,000	
Pension		15,000	$30,000
Total	$30,000	$30,000	$30,000
Adjusted Gross Income	$30,000	$15,000	$ 0
Taxable Income	25,840	10,840	(4,160)
State Income Tax	1,888	567	0
Tax Credits	0	32	196
Actual Tax Paid (Refund)	1,888	535	(196)

*Hawaii's income tax is similar in scope and structure to that of many other states.

**Family A = Husband, wife, and two children.
Family B = Husband and wife, both age 65 or over.
Family C = Husband and wife, both age 65 or over.

There are two reasons a state may want to have a progressive income tax. A progressive income tax may be called for to offset regressivity of other taxes, e.g., general and selective sales taxes and, with less certainty, the property tax. Second, a progressive income tax provides a tax base that is more responsive to economic growth. Revenues from a progressive tax will grow faster than the growth of income as taxpayers enter higher tax brackets. This so-called elasticity would offset less responsive (inelastic) revenue yields from other taxes.

A progressive income tax can be achieved in a number of ways. The most apparent of these is through a graduated rate structure where tax rates increase as income increases. This is done in 33 of the 40 states that levy broad-based income taxes. In 14 of these states, the highest marginal tax rate is 10 percent or greater.

Even in the absence of a progressive tax rate structure, progressivity is still possible. Personal exemptions, standard deductions, and tax credits that are defined in terms of a fixed-dollar amount are progressive in that they reduce the tax liability of low-income taxpayers proportionately more than for high-income taxpayers. If the dollar amounts are phased out as income increases, progressivity is further enhanced. This is done in Wisconsin where the standard deduction is phased out at $77,000 of income and in Hawaii where tax credits "vanish" when adjusted gross income reaches $20,000.

The definition of what income is taxable also affects the degree of progressivity of the tax. Progressivity is enhanced by excluding from taxation income that accrues primarily to low-income families, e.g., welfare benefits and unemployment compensation, or by taxing income that tends to be concentrated at high levels of income. Thus, the income tax in Connecticut, which is imposed only on dividend, interest, and capital gains income, is progressive.

Still another way of introducing progressivity is by placing floors tied to income levels on itemized deductions. For example, by limiting deductions for medical expenses to those in excess of 5 percent of adjusted gross income, low-income taxpayers are more likely to qualify for the deduction than high-income taxpayers. Progressivity can also be achieved by defining the state tax liability as a percentage of the federal income tax liability, as is done by Nebraska (until 1987), Rhode Island, and Vermont. Since the federal income tax is progressive, the state tax would also be progressive.

Constraints on Tax Rates

There appear to be both political and economic limits on the degree to which state income tax rates can be used to achieve progressivity. The political constraint is evident in the fact that few states have marginal tax rates that top 10-15 percent. This may be because of a desire not to be out of line with other states and thereby be branded as a "high-tax" state. The political environment is also colored by federal tax policies, which since 1964 have been aimed at lowering the top marginal tax rate, culminating in the Tax Reform Act of 1986. Some economic rationales support these changes. High marginal rates can create inefficiencies because eco-

nomic decisions are made on the basis of tax avoidance rather than on the true economic concerns.

Apparent versus Actual Progressivity

The degree of progressivity of a state's income tax is determined by both visible characteristics of the tax discussed above, as well as by more subtle provisions not generally apparent. For example, the preferential treatment of state and local bond interest income and capital gains introduces regressivity into the system since such income is concentrated at high-income levels. Further, 16 states allow deductibility of federal income tax to determine state taxable income. Since higher income taxpayers have higher federal liabilities, these deductions are regressive. (Seven of the sixteen states either limit the deduction or subject taxpayers to higher rates if the deduction is taken.) Progressivity is also a function of income distribution within a state. For example, if most of the state taxpayers are in the top tax-rate brackets, progressivity is reduced because income growth will not result in higher liabilities.

The variety of ways in which progressivity and regressivity can be introduced into an income tax implies that those interested in tax fairness must be aware of many aspects of the tax code. A tax code that appears to be progressive may have subtle features that effectively render it much less progressive. Conversely, a tax that has the appearance of proportionality may indeed be progressive because of provisions that are not readily apparent. Table 7 summarizes not only the more obvious features that affect equity but also those subtle provisions.

TABLE 7. Income Tax Features That Contribute to Progressivity and Regressivity

Progressive Features	Regressive Features
Graduated tax rates	
Wide tax brackets	Narrow brackets
Fixed dollar standard deduction, exemptions, and credits	Standard deduction and exemptions defined as a fixed percent of income
Itemized deductions that are limited by income level	Unlimited itemized deductions
	Deductibility of Federal and state income taxes
Exclusion of unemployment compensation and welfare benefits	Full or partial exclusion of capital gains, interest, and dividend income
Tax credits targeted toward low-income taxpayers	Tax credits available to all taxpayers
Broad tax base	Narrowly defined loopholes
Inflation-adjusted standard deduction, exemptions, and brackets	Constant tax structure in presence of inflation
Conformity to federal income tax base	Divergence from federal income tax base

Given the complexity of defining and measuring tax progressivity, it is difficult to compare progressivity among states and over time. Nevertheless, some insight may be gained by the data presented in Table 8. Here, the

elasticity of the income tax is measured for each of the states that levy a broad-based income tax. (Elasticity equals the percentage increase in tax revenues when each taxpayer's income is increased by 1 percent.) The higher the elasticity, the greater the progressivity. Two outcomes are apparent. First, as is evidenced by the declining average elasticity, progressivity declined over the period studied. This is a result of inflation and real growth pushing taxpayers into higher tax brackets and the failure of fixed-dollar deductions, exemptions, and credits to keep pace with inflation.

TABLE 8. Degree of Responsiveness of State Personal Income Taxes to Changes in Taxpayers Incomes*

State	1977	1979	1981	1983
NEW ENGLAND				
Maine	2.03	1.99	1.89	1.81
Massachusetts	1.31	1.23	1.29	1.29
Rhode Island	1.73	1.73	1.72	1.71
Vermont	2.06	1.70	1.70	1.68
MIDEAST				
Delaware	1.64	1.61	1.56	1.54
Maryland	1.33	1.29	1.26	1.23
New Jersey	1.55	1.50	1.47	1.40
New York	1.69	1.68	1.56	1.57
Pennsylvania	1.09	1.03	1.05	1.03
SOUTHEAST				
Alabama	1.32	1.24	1.18	1.18
Arkansas	1.58	1.54	1.50	1.47
Georgia	1.70	1.62	1.52	1.48
Kentucky	1.43	1.35	1.28	1.26
Louisiana	2.23	2.02	2.48	2.20
Mississippi	2.00	1.88	1.89	1.88
North Carolina	1.47	1.43	1.41	1.38
South Carolina	1.73	1.60	1.54	1.50
Virginia	1.62	1.57	1.47	1.44
West Virginia	1.50	1.53	1.52	1.77
GREAT LAKES				
Illinois	1.21	1.17	1.15	1.14
Indiana	1.17	1.14	1.21	1.18
Michigan	1.44	1.36	1.41	1.32
Ohio	1.76	1.69	1.63	1.74
Wisconsin	1.92	2.16	1.88	1.71
PLAINS				
Iowa	1.47	1.54	1.41	1.43
Kansas	1.56	1.54	1.53	1.52
Minnesota	1.85	1.93	1.80	1.82
Missouri	1.69	1.60	1.53	1.49
Nebraska	2.01	1.93	1.99	1.86
North Dakota	1.78	1.62	2.06	1.62
SOUTHWEST				
Arizona	1.41	1.44	1.77	1.76
New Mexico	3.80	3.27	3.37	2.43
Oklahoma	1.98	1.90	1.80	1.78
ROCKY MOUNTAINS				
Colorado	1.57	1.55	1.44	1.47
Idaho	1.68	1.58	1.55	1.49
Montana	1.42	1.49	1.43	1.50
Utah	1.37	1.29	1.21	1.20
FAR WEST				
Alaska	1.52			
California	2.06	2.03	2.17	2.14
Hawaii	1.54	1.46	1.50	1.53
Oregon	2.05	2.05	1.91	1.67
UNWEIGHTED AVERAGE	1.69	1.63	1.63	1.57
FEDERAL INCOME TAX	1.75	1.77	1.73	1.72

SOURCE: Daniel R. Feenberg and Harvey S. Rosen, "State Personal Income and Sales Taxes: 1977-1983," National Bureau of Economic Research, Working Paper No. 1631, June 1985.

*The numbers presented in this table show income elasticities. Elasticity measures the percentage increase of income tax revenues that results from a 1-percent increase in every taxpayer's income. An elasticity of 1.5 implies that when taxpayers' incomes increase by 1 percent, income tax revenues increase by 1.5 percent. The greater the elasticity value, the greater the progressivity of the income tax.

Second, the states with the greatest degree of progressivity are not necessarily those with the highest marginal rates. Louisiana, with its highly elastic tax law has a marginal rate of only 6 percent but it has wide brackets and generous exemptions and deductions. New Mexico's top marginal rate is 7.8 percent but that does not apply until taxable income is $100,000. Combined with liberal exemptions and deductions this creates a highly elastic and thus progressive income tax. Several states with flat rate income taxes (Illinois, Indiana, and Pennsylvania) have taxes that do not appear to be very progressive. However, Massachusetts and Michigan, which similarly have flat rate taxes show a greater degree of progressivity. For Massachusetts, this is explained by the fact that dividends, interest, and capital gains are taxed at a higher flat rate.

Inflation and Indexing

In the presence of progressive taxes, inflation has multiple, and sometimes deleterious, effects. A graduated rate structure means that inflationary income growth will result in even higher revenue growth since taxpayers are pushed into higher tax brackets. To the degree that revenues increase faster than costs faced by government, the government is the recipient of an inflationary "bonus"; revenues increase without having to enact legislation. However, jurisdictions at different levels will experience different degrees of "benefit" from inflation. The federal government with its highly elastic revenue sources is the greatest beneficiary, followed by states with elastic tax systems. Local governments generally have inelastic revenue sources and thus experience inflation-induced cost increases without offsetting revenue growth.

In the absence of corrective legislation, inflation reduces the progressivity of state income taxes. It hurts low-income taxpayers more than those toward the top of the distribution. Inflationary growth in the income of low-end taxpayers pushes them into higher tax brackets more rapidly since brackets are generally narrower and rates rise faster at the bottom of the rate structure. Inflation erodes the value of fixed-dollar exemptions and standard deductions that are supposed to protect low-income taxpayers from excessive tax liability. On the other hand, taxpayers already at the top brackets cannot be pushed into significantly higher brackets as a result of inflation. At the same time, these taxpayers generally take advantage of itemized deductions, which are inflation-proof. For example, as taxpayers' medical expenses, interest costs, property taxes, etc., increase because of inflation, their itemized deductions will also increase.

Indexing is often proposed as a means to offset the undesirable effects of inflation. This involves adjusting the dollar-defined tax provisions such as personal exemptions, standard deductions, tax brackets, and tax credits for inflation that has been experienced. A tax system that is fully indexed would thereby protect taxpayers from ever-increasing tax burdens, would remove the "inflation bonus" that can accrue to some governments, and would maintain the equity of the tax structure. On the other hand, indexing reduces tax revenues and increases pressure on public sector decisionmakers to evaluate carefully their spending policies.

Indexing can be achieved through the automatic application of formulas or by discretionary legislative actions. Between 1978 and 1985, 10 states enacted some form of formula indexing. Whenever formulas are used, a number of issues arise: which measures of inflation should be used (usually it is the Consumer Price Index)?; what tax provisions should be indexed?; how often should indexing occur?; and should it be automatic or conditional on legislative approval? Since the Consumer Price Index generally overstates the degree of inflation, especially the degree to which incomes are inflated, care must be exercised in its use. Formula indexing can be particularly harmful to fiscal stability if a state experiences an inflationary recession. The recession will result in falling incomes and tax receipts while inflation will prompt further reductions in revenues because of indexing. Given the difficulties with formula indexing, most states have opted to make periodic discretionary adjustments in income taxes to offset the effects of inflation.

The Income Tax as a Social and Economic Policy Tool

Once a tax is in place, there seems to be an uncontrollable desire to enact special provisions in the hope that these incentives will stimulate socially or economically desired activity. Federal and state income taxes are replete with narrow exclusions, deductions, check-offs, and credits. The more publicized of these preferences include the oil depletion allowance and real estate tax shelters, which in some cases allowed high-income taxpayers to escape paying any tax.

There are also numerous preferences with various social goals. For example, most states that tax income exclude all or part of pension and social security income from the tax base and provide other preferences to ease the tax burden on elderly taxpayers. Thirty states plus the District of Columbia provide tax credits or deductions for child care expenses. Many states provided tax preferences for alternate energy and energy conservation investments. States are also making increased use of "check-offs" whereby a taxpayer can designate if a certain amount of his tax liability (e.g., $2) is to be placed in a specific trust fund to finance, for example, election campaigns or child abuse prevention, as is done in 12 states.

While many of the tax preferences noted here are popular, it should be recognized that they do have costs. Preferences reduce the tax base and this implies that tax rates must be higher to yield the same revenues. High rates may have detrimental effects on economic decisions and may form a point of focus for public resistance to taxes. Preferences also create inequities by removing the link between income and ability to pay. As a result, it is not the amount of income but the type of income and the use of that income that determine tax liability. Preferences also increase the complexity of the tax, increase the reporting and filing requirements for taxpayers, and add to the costs of administering the tax.

It should be clearly understood that by supporting particular goals through tax preferences these goals are effectively assigned a higher priority than those for all other state programs. State programs funded via direct expenditures are subject to review through the budget process, and priorities are thereby established. Tax preferences, however, once enacted, create automatic support that is implicitly of the highest priority because the government "spends" the money by not collecting it. Other programs, e.g., education, must then compete for the remaining diminished resources.

Once preferences are enacted, they are difficult to remove even if they fail to achieve their desired ends. Policy makers should thus consider building in automatic "drop dead" or "sunsetting" provisions when preferences are inserted into an income tax.

Conformity of Income Taxes

The lack of conformity among federal, state, and local income taxes is a frequent source of taxpayer frustration. In practice, conformity can vary by degree. Table 9 summarizes the extent to which states conform with federal definitions. Full conformity, also known as "piggybacking," occurs when the state tax liability is defined as a percentage of the federal liability. By piggybacking, the taxing jurisdiction adopts the tax features of the other jurisdiction. States that piggyback on federal tax liability (Nebraska until 1987, Rhode Island, and Vermont), essentially adopt the relatively high progressivity and elasticity of the federal income tax. Piggybacking also occurs at the local level. In seven of the thirteen states that have local income taxes, the local tax is defined as a percent of the state liability. Partial conformity can be achieved if the state uses federal taxable income or federal adjusted gross income as a starting point for calculating state taxes. Nonconformity occurs if the state does not incorporate federal tax definitions.

In spite of piggybacking's attractiveness to taxpayers, most states and the District of Columbia opt for only partial conformity with federal definitions (Table 8). State legislators are apparently reluctant to relinquish their autonomy over their taxes. This is owing in part to the uncertainties that are created when Congress alters tax laws, frequently late in the year. In addition, the federal tax structure is

influenced by its intended purpose of redistributing income and wealth and promoting macroeconomic policy goals. Since state and local income taxes exist to generate revenues, some federal income tax policies may not be appropriate.

Tax Competition

In an age of rapid economic change and mobile resources, states and localities often compete fiercely to retain and attract business. This has led some to emphasize an attractive "business climate" that features policies to reduce taxes, keep wage costs low, and promote a reliable labor pool. From a national perspective, these policies make sense only in the very rare case that they keep business from going abroad. At the state and local level, however, there seems to be an irresistible urge to "beggar thy neighbor" in the hope of enriching oneself.

Policies that purport to improve the business climate by reducing taxes and providing other financial inducements can have unanticipated effects. They will attract businesses that might not be viable in the absence of such subsidies. These are not the types of businesses that can contribute to a long-term economic base; rather, they are likely to subsequently move to other, lower-cost locations. Actions to reduce taxes inevitably require actions to reduce spending. Since government spending on infrastructure, education, and public amenities provides an environment in which businesses and their employees can compete and thrive, erosion of the tax base by offering special tax benefits may have the effect of driving away the very economic development that is desired.

TABLE 9. Conformity of State Income Taxes with Federal Tax Laws, As of October 1986

State	Tax Base*	Federal Itemized Deductions*
NEW ENGLAND		
Maine	FAGI	X
Massachusetts	FAGI	
Rhode Island	FL	X
Vermont	FL	X
MIDEAST		
Delaware	FAGI	X
Dist. of Columbia	FAGI	X
Maryland	FAGI	X
New Jersey	—	
New York	FAGI	X
Pennsylvania	—	
SOUTHEAST		
Alabama	—	
Arkansas	—	
Georgia	FAGI	X
Kentucky	FAGI	X
Louisiana	FAGI	X
Mississippi	—	X
North Carolina	—	
South Carolina	FTI	X
Virginia	FAGI	X
West Virginia	FAGI	X
GREAT LAKES		
Illinois	FAGI	
Indiana	FAGI	
Michigan	FAGI	
Ohio	FAGI	
Wisconsin	FAGI	
PLAINS		
Iowa	FAGI	X
Kansas	FAGI	X
Minnesota	FAGI	X
Missouri	FAGI	X
Nebraska	FL	X
North Dakota	FTI**	X
SOUTHWEST		
Arizona	FAGI	X
New Mexico	FAGI	X
Oklahoma	FTI	X
ROCKY MOUNTAINS		
Colorado	FAGI	X
Idaho	FTI	X
Montana	FAGI	X
Utah	FTI	X
FAR WEST		
California	FAGI	X
Hawaii	FTI	X
Oregon	FTI	X

SOURCE: Federation of Tax Administrators.

NOTES:
*Subject to state modification
**North Dakota: or current FL, taxpayer's option.

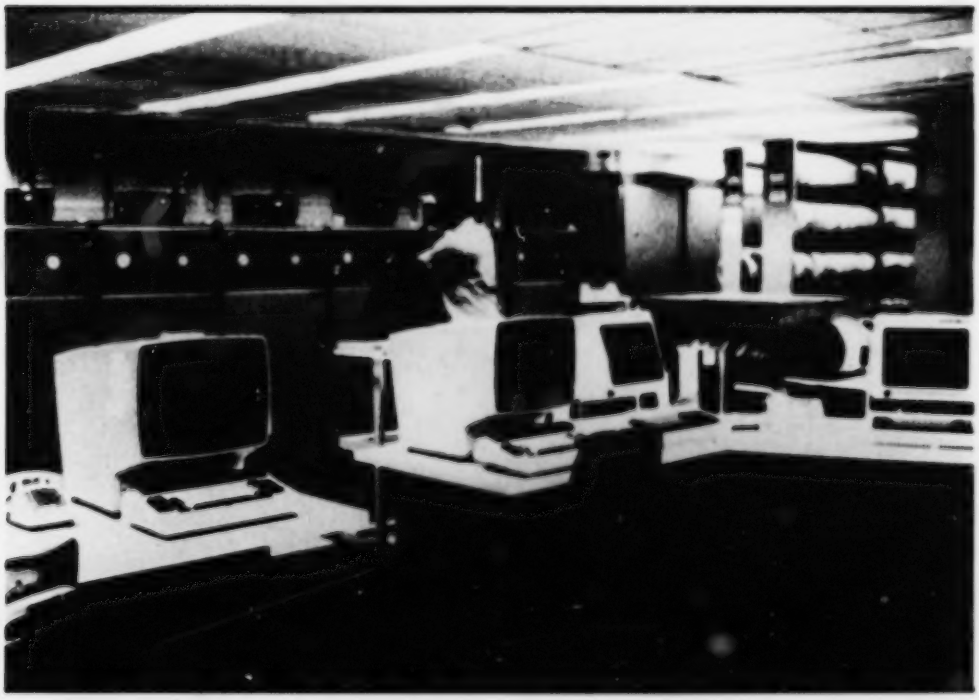
LEGEND:
—: indicates state does not employ a federal starting point
FAGI: Federal adjusted gross income
FTI: Federal taxable income
FL: Federal liability (piggybacking)

Potential for Additional Revenues

Extension of Income Tax

With few exceptions, state and local governments are usually under pressure to reduce costs and/or to increase tax revenues. The individual income tax represents one potential source for added tax revenues that can be both fair and efficient. In 1985, individual income taxes accounted for 30 percent of total state tax receipts and 5 percent of local tax collections, but for some states and most localities the income tax is not used at all. Additional revenues can thus be achieved by extending the tax to jurisdictions that do not now use it. In addition, governments that make relative light use of the tax could tax income more intensively. Even those governments that do levy broad-based income taxes can increase collections in ways that are not necessarily objectionable to taxpayers.

An income tax can be part of a diversified revenue structure making use of the conventional revenue sources: income taxes, sales (consumption) taxes, property taxes, severance taxes, and fees and charges. By relying on a variety of revenue sources, there is less chance of revenue fluctuations because of economic crises or judicial or political challenges to a tax. The vast experience of states in taxing income suggests that the administering of a new income tax should be manageable, especially if it conforms closely to the federal income tax.



Localities may also find income taxes particularly attractive. A local income tax can be a productive source of revenue. (See Table 5.) This occurs despite restrictions on the power of local governments to establish tax rates and taxable income bases.

Increased Intensity in Using Income Taxes

For states that already levy a broad-based income tax, increased collections can occur only through closing loopholes or raising tax rates. The latter can be achieved in several ways, none of which is without drawbacks. Statutory tax rates can be increased uniformly or differentially across brackets. However, rates are highly visible and subject to comparisons with the rates of other states. Raising rates also runs counter to the federal trend to lower marginal tax rates so as to minimize the incentives to make economic decisions strictly on the basis of tax considerations.

As an alternative to raising rates, states may choose to reduce the width of the tax brackets (which effectively raises the rates). Depending on the distribution of income, this reduces the progressivity and elasticity of the tax. Alternatively, the value of exemptions, standard deductions, and credits can be reduced, but this is generally a highly regressive way of increasing revenues. On the other hand, if exemptions, deductions, and credits are phased out as income increases, the base can be broadened in a progressive manner.

Rather than raising tax rates in the ways noted above, a state may opt to expand its tax base by closing loopholes. These narrow preferences are costly and frequently have dubious value to the general public. Removing the preferences contributes to a more equitable tax by enhancing the link between ability to pay and actual tax paid. States are finding that by adopting the base-broadening provisions of the Federal Tax Reform Act of 1986, revenues can be increased even after lowering rates. So as to ensure that filers pay at least some income tax regardless of the loopholes that taxpayers may find, the federal government has for some time levied an "alternative minimum tax." States may find this an acceptable way of closing loopholes.

Findings and Choices for Educators

The National Education Association finds that the income tax is and should continue to be an important source of revenues for states and localities. Furthermore, the income tax can be levied in a manner that is equitable to taxpayers and easy for them to comply with. NEA therefore recommends that the following policies should be pursued in relation to achieving a productive, fair, and efficient state income tax.

- The income tax has become an integral part of the diversified revenue systems of 37 of the 50 states. A diversified revenue base protects jurisdictions from fluctuations in tax collections because of economic, political, and/or legal problems.
- The income tax should be levied on a broad basis with few exclusions. Since the federal income tax base, especially after the Tax Reform Act of 1986, is broad-based, close conformity to federal definitions is, at minimum, desirable. By maintaining a broad tax base, income tax rates can be kept low while maintaining adequate revenues.
- The income tax should have a progressive rate structure to offset regressivity of other state and local taxes and to provide revenues that expand and contract with changes in the economy.
- As part of the progressive tax rate structure, the income tax should protect subsistence income from taxation by providing adequate dollar-defined personal exemptions, standard deductions, or tax credits targeted at low-income taxpayers.
- Efforts to provide narrow tax preferences should be resisted since these erode the income tax base. The burden of proof should be on those desiring the preferences that these policies are both necessary and effective, and the use of tax preferences should be considered only after other, more direct, government assistance programs are ruled out. Simplicity is also enhanced by minimizing tax preferences that seek to promote social goals.
- To keep the income tax simple, the state tax should conform with federal income tax definitions to the maximum extent deemed feasible.
- Tax rate brackets, exemptions, deductions, and credits should be adjusted periodically to reflect their changing value in light of inflation. While formula indexing should be avoided, discretionary adjustments to reflect inflation can maintain the progressivity and elasticity of the tax without large revenue losses.
- Local governments that have inadequate revenue sources compared to expenditure responsibilities should have access to income taxes.
- To promote ease of taxpayer compliance and administration, the local tax base should be limited to wages or piggybacked on state taxable income or tax liability. Rates should be restricted to minimize interjurisdictional competition for persons and jobs based on tax considerations.
- To insure that the process of self-assessment is an equitable one, state and local tax administrators should

be provided with adequate resources to administer the income tax and to audit taxpayers. Cooperation among states and between state and federal administrators should be encouraged.

The income tax can contribute substantially to revenue diversification in state and local tax systems and thereby assure these governments of revenues responsive to changing economic, political, and social conditions.

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